IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 1732-75

In the Matter of
QUANTUM DEVELOPMENT CORPORATION,
Debtor.

FIRST NATIONAL CITY BANK,
Petitioner,

v.

AMERICAN FIDELITY FIRE INSURANCE COMPANY,
CHARLES JOY, RECEIVER,
CHARLES TAIT, TEMPORARY RECEIVER,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF RESPONDENT AMERICAN FIDELITY FIRE INSURANCE COMPANY IN OPPOSITION TO PETITION

LEO H. HIRSCH, JR.
Counsel for Respondent
American Fidelity Fire Insurance Company
60 East 42nd Street
New York, N.Y. 10017

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Opinions Below

The opinion of the Court of Appeals is not reported. The opinion of the District Court is reported at 397 F. Supp. 329 (D.V.I., 1975).

Jurisdiction

The judgment of the Court of Appeals was entered March 24, 1976.

Petitioner's petition for rehearing and for rehearing en banc was denied by the Court of Appeals April 21, 1976.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented

Where a bank which has not been designated as an authorized depository for bankruptcy funds by the District Court under whose supervision a bankruptcy receiver is acting accepts from such receiver funds which the bank knows are bankruptcy funds and in exchange gives him a certificate of deposit in his individual name, upon the maturity of which it transfers the proceeds outside the jurisdiction to his individual credit, is the bank liable as trustee *ex maleficio* to account for the return of the funds to the bankruptcy estate?

Statute Involved

The statutory provisions involved are Sections 47(a) and 61 of the Bankruptcy Act, 11 U.S.C. §§ 75(a), 101, which are set forth in Appendix C to the petition.

Statement

Respondent American Fidelity Fire Insurance Company accepts petitioner's statement (pet., pp. 2-5), subject to the following corrections and additions.

1. The order of April 13, 1973 directing the receiver to deposit the sum of $115,211 was not made by the "district court, sitting as a bankruptcy court" (pet., p. 3) but by Hon. Rafael Rivera Cruz (JA 2 # 16),* then Referee in Bankruptcy (PA 6a, ftn. 3), although sometimes called "Bankruptcy Judge" (PA 23a).

2. The application for the certificate of deposit signed by Joy requested that the certificate of deposit be issued in favor of "Charles R. Joy, Receiver" (JA 29). It was in fact issued in favor of "Charles R. Joy" (JA 31).

3. We disagree with petitioner's claims that it had no notice Joy intended to abscond and that "there is no suggestion that any inquiry, however searching, would have uncovered this foul purpose" (pet., p. 4). When petitioner transferred the funds to Miami, it knew:

> (a) That the funds were bankruptcy funds. (This is apparent from the face of the $115,211 check [JA 30].)
>
> (b) That the funds were being held pending the further order of the bankruptcy court. (That is what was provided in the order of April 13, 1973 [JA 36] referred to on the face of the check.)
>
> (c) That there could be no possible reason for sending the funds out of the Virgin Islands to Joy's individual credit. (As noted in the petition [p. 3], Quantum had been engaged in construction in the Virgin Islands. Any off-island creditors could and should have been paid by check.)
>
> (d) That the amount involved was extraordinarily large, particularly for a person in Joy's economic status. (Petitioner's own records showed he was chief engineer of a hotel [JA 32] who requested that his charge limit be increased to $1000 [JA 34].)

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* References preceded by "JA" are to the Joint Appendix in the Court of Appeals; those preceded by "PA" to the Appendix to the petition herein.

Surely, it would not have taken a modern Sherlock Holmes to deduce from the foregoing that something foul was in progress.

Argument

Respondent respectfully submits (a) that certiorari is not warranted in this case and (b) that the decision of the Court of Appeals herein was correct.

(A) Certiorari Is Not Warranted

Over 32 years ago, on May 29, 1944, this Court denied, *First National Bank in West Union, West Virginia* v. *American Surety Company of New York,* 322 U.S. 754, a petition to review the decision of the Court of Appeals for the Fourth Circuit, *American Surety Company of New York* v. *First National Bank in West Union, West Virginia,* 141 F2d 411 (1944), holding that a bank which, though not designated to accept bankruptcy funds, knowingly accepts such funds becomes liable as a trustee *ex maleficio.* In that case, the petitioning bank (pet., pp. 24-31) cited, to show a conflict, the decisions of the Sixth and Seventh Circuits relied on by petitioner herein, *Irving Trust Co.* v. *United States,* 83 F2d 20 (CA6, 1936), *cert. den.* 298 U.S. 686 (1936); *In re Bogena & Williams,* 76 F2d 950 (CA7, 1935).

During the intervening years, at least so far as the reported cases reveal, the problem did not arise until the instant case. The reason is not hard to understand. For such a problem to be presented it is necessary both (1) that a non-designated bank knowingly accepts bankruptcy funds and (2) that either (a) the fiduciary embezzles the funds or (b) the bank fails and the amounts involved exceed the limit of FDIC insurance, 12 U.S.C. § 1821. Fortunately, it is very rare that both these requirements are satisfied in a single case, particularly with the advent of FDIC.

Since the question of the liability of non-designated depositories appears to occur only once every thirty years, it is not the sort of conflict among Circuit Courts of Appeals, assuming there is a true conflict, that requires the attention of this Court. It does not concern an important question nor one likely to produce continuing consequences in the foreseeable future.

Furthermore, a resolution of the alleged conflict would not terminate this case. The District Court decided against petitioner on an entirely different ground from the alleged conflict, to wit, because of the issuance by petitioner of the certificate of deposit to Joy personally "in the face of unambiguous instructions" to issue it to him as receiver (PA 33a). The Court of Appeals did not reach this question (PA 17a). Therefore, were the petition to be granted and the judgment of the Court of Appeals reversed, it would be necessary to remand the case to the Court of Appeals for consideration of the question it did not reach, followed perhaps by another petition to this Court. Such prolongation of litigation is not warranted to resolve an alleged conflict on a matter of negligible practical consequence.

Finally, it is respectfully submitted that there is no true conflict between the decision of the Third Circuit herein and that of the Fourth Circuit in *American Surety Company of New York* v. *First National Bank in West Union, West Virginia, supra,* on the one hand and those of the Sixth and Seventh Circuits in *Irving Trust Co.* v. *United States, supra,* and *In re Bogena & Williams, supra.* In the two former cases the banks remained solvent and the consequences of holding them trustees *ex maleficio* fell on them whereas in the latter two cases the banks failed and the consequences would have fallen on their depositors. The concept of constructive trusts is of equitable origin, see *Healy* v. *Commissioner of Internal Revenue,* 345 U.S. 278, 282 (1953), and it is not inequitable to consider the

consequences of a decision and to avoid the punishment of innocent persons.

The Court of Appeals for the Sixth Circuit concluded its opinion in *Irving Trust, supra,* after pointing out that the bankruptcy trustee could have required a bond from the bank, by stating: "It would be inequitable to require the repayment to it [the bankruptcy trustee] of the balance in its account at the time the bank closed in preference to the claims of others who similarly failed to require bonds to protect their deposits" (83 F2d at 24-25). The Court of Appeals for the Fourth Circuit in *American Surety, supra,* said of *In re Bogena & Williams, supra,* and *Irving Trust, supra:*

> ". . . we do not think that they should control our decision here. They were concerned, not with the liability of the bank to the bankrupt estate, but with the right of the estate to preferential treatment in distribution of assets of banks which had become insolvent, and the effect of the decisions was to place the claims of the bankrupt estates on an equal basis with other depositors." (141 F2d at 414-415).

Finally, this distinction was recognized by the Court of Appeals for the Third Circuit herein (PA 12a, ftn. 14).

The net result of the four cases is that a bankruptcy estate whose funds are deposited in a non-designated bank may hold the bank liable as a trustee *ex maleficio* but has no priority over other depositors in case of the failure of the bank. Such a rule is reasonable and equitable and, since the result of all four cases is consistent with it, shows that there is no real conflict.

(B) The Decision of the Court of Appeals was Correct

Petitioner does not claim that any of its branches in the Virgin Islands had ever been designated by a Judge of the District Court of the Virgin Islands as depositories

pursuant to Section 61 of the Bankruptcy Act, 11 U.S.C. § 101.

It makes no difference that a District Judge in Puerto Rico had designated petitioner's branches there, for a designation is effective only as to estates administered in the District in which the District Judge sits. *Irving Trust Co.* v. *United States, supra,* 83 F2d at 22. The instant bankruptcy proceeding is, of course, being administered in the District Court of the Virgin Islands.

It also makes no difference that, on September 10, 1973, when petitioner's Christiansted branch received the check and issued the certificate of deposit in Joy's individual name, no other bank in the Virgin Islands had been designated as a depository for bankruptcy fund.* Joy, or his counsel, could have applied to one of the District Judges in the Virgin Islands to make such a designation.

Finally, it makes no difference that Referee Rafael Rivera Cruz in the order of April 13, 1973 directed Joy to deposit the funds "in a separate, interest-bearing account" (JA 36). This cannot be deemed the equivalent of a designation of whatever bank Joy might select, for a variety of reasons, the most important of which is that at the time of the order and at the time petitioner received the check, no Referee in Bankruptcy had power to designate a depository. That power was then vested under Section 61 of the Bankruptcy Act, 11 U.S.C. § 101, in the District Judges.** The Referees did receive such power under Rule 512(a) of the new Bankruptcy Rules, but those

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* It is of interest to note that a similar plea was made in the unsuccessful petition for certiorari in *First National Bank in West Union, West Virginia* v. *American Surety Company of New York, supra,* at page 33 of which it was stated: "There was no such depository at all in Doddridge County, where Petitioner's bank is located."

** Referees were specifically excluded from the definition of "Judge", Bankruptcy Act, § 1(20); 11 U.S.C. § 1(20).

Rules did not take effect until October 1, 1973 as to ordinary bankruptcies and until July 1, 1974 as to Chapter XI proceedings. Quantum was in Chapter XI until November 30, 1973, when it was adjudicated bankrupt. Furthermore, before a designation becomes effective, a bond must be filed by the bank, *In re Potell,* 53 F2d 877, 878 (E.D., N.Y. 1931), as required by Section 61. Referee Cruz's order, of course, makes no reference to a bond and it is not claimed that petitioner filed one in the Virgin Islands.

It is thus clear that the Christiansted branch of petitioner was not a designated depository on September 10, 1973. General Order 53(5) then provided that "No receiver . . . shall deposit with any one depository funds . . . in excess of the amount of the bond of such depository then in force". This General Order applied to Chapter XI proceedings, General Order 48(2). Section 47(a) of the Bankruptcy Act, 11 U.S.C. § 75(a), also applicable to Chapter XI proceedings, Section 302 of the Bankruptcy Act, 11 U.S.C. § 802, provides that "Trustees shall . . . (2) deposit all money received by them in designated depositories . . ." Accordingly, Joy had no right to deposit the funds of the estate with petitioner.

Such illegal deposit makes clearly applicable *Restatement (Second) of Trusts,* § 324, comment b (1957), quoted at the top of PA 13a, stating that a bank which accepts a deposit from a fiduciary with notice or knowledge that such deposit is forbidden is chargeable as a constructive trustee of the funds.

Notice that the funds were bankruptcy funds was given petitioner by the face of the check (JA 30). The illegality of the deposit is a matter of law, of which petitioner is presumed to have knowledge and with notice of which it is chargeable.

Federal Crop Insurance Corporation v. *Merrill,*
332 U.S. 380, 384 (1947);

Anderson National Bank v. *Luckett,* 321 U.S. 233, 243, 244 (1944);
IV Scott on *Trusts* (3d Ed., 1967), § 324.1.

The consequences of being a constructive trustee are not a mere liability for damages. He is liable to the beneficiary except to the extent the trust estate has received the benefits of any payments he has made.

Restatement (Second) of Trusts, § 291(3) and Comment o thereto;
Fidelity & Deposit Co. of Maryland v. *People's Bank,* 44 F2d 19, 20-21 (CA8, 1930), *cert. den. sub nom. People's Bank* v. *Fidelity & Deposit Company of Maryland,* 282 U.S. 901 (1931);
Central Stock & Grain Exchange of Chicago v. *Bendinger,* 109 Fed. 926 (CA 7, 1901), *cert. den.* 183 U.S. 699 (1901).

In *Fidelity & Deposit, supra,* it was said:

"In the instances where the banks received from the county treasurer county funds and placed them on deposit when they were not legal county depositories, they became trustees ex maleficio. Merchants' Nat. Bank v. School Dist. (C.C.A.) 94 F. 705; Bd. of Comm'rs v. Strawn (C.C.A.) 157 F. 49, 15 L.R.A. (N.S.) 1110; U.S.F. & G. Co. v. Union Bk. & Tr. Co. (C.C.A.) 228 F. 448; American Sur. Co. v. Jackson (C.C.A.) 24 F. (2d) 768; Fiman v. State of South Dakota, 29 F. (2d) 776 (C.C.A.8); Compton v. Farmers' Tr. Co., 220 Mo. App. 1081, 279 S.W. 746. As such their absolute liability could be relieved only by restoring the funds to the county. The banks in becoming trustees ex maleficio lost their right to presume that the county treasurer in withdrawing the funds would make proper disposition thereof. Perry on Trusts (7th Ed.) vol. 1, § 245; Central Stock &

Grain Exchange v. Bendinger (C.C.A.) 109 F. 926, 56 L.R.A. 875; U.S.F.&G. Co. v. People's Bank, 127 Tenn. 720, 157 S.W. 414; Glasgow v. Nicholls, 124 Wash. 281, 214 P. 165, 168, 35 A.L.R. 419." (44 F.2d at 20-21).

The foregoing authorities dispose of petitioner's claim, twice made on page 6 of the petition, that the Court of Appeals herein fashioned a "novel" rule. *Fidelity & Deposit, supra,* answers petitioner's efforts (pet., pp. 8-9) to distinguish the public funds cases cited by the Court of Appeals on the ground that in those cases the banks failed. The banks involved in *Fidelity & Deposit, supra,* appeared to have remained solvent at the time of the decision of the Court of Appeals; the litigation was against the banks and not their liquidators.

Petitioner's attempt (pet., p. 10) to explain away the decision of the Court of Appeals for the Fourth Circuit in *American Surety, supra,* ignores the plain language of the opinion in that case. Petitioner states (p. 10): "The breach of trust resulting in liability to the bank was not the acceptance of the unauthorized deposit . . ." Judge Parker, writing for the unanimous Court of Appeals, repeatedly stated that it *was* the acceptance of the deposit with knowledge that bankruptcy funds were involved that made the bank liable as trustee *ex maleficio.* See 141 F2d at 413, 414, 415, 416, 417. The *American Surety* case is indistinguishable from the instant one, and, just as the bank there involved was not released from liability although the trustee individually and his wife "gradually checked out by checks" the funds in question (141 F2d at 412), so the fact that Joy individually received all the funds involved herein is no defense. The test is whether the funds were restored to the estate, *American Surety, supra,* 141 F2d at 417; *Fidelity & Deposit, supra,* 44 F2d at 20.

The fact that the Referee in Bankruptcy directed Joy to deposit the funds in an interest-bearing account is no

defense available to petitioner. In *Allen* v. *United States,* 285 Fed. 678, 681 (CA1, 1923), a bank which accepted without statutory authority deposits of post office funds from the Superintendent of one of the Boston postal stations was held liable as trustee *ex maleficio* despite the fact that the deposits had been made with the knowledge and consent of the Boston Postmaster. In the instant case the Referee had no authority to authorize Joy to violate the Bankruptcy Act. Furthermore, no violation of law was needed for Joy to comply with the Referee's order; Joy could have had a depository designated by a District Judge.

There is no basis for petitioner's claim (pet., p. 8) of a "windfall" for creditors of the bankrupt resulting from the decision below. No claim can be made that any creditor will receive more than he would have received if petitioner had properly handled the proceeds of the $115,211 check, which it might have done if its Christiansted Branch had been designated and the personnel of that branch had been instructed how bankruptcy accounts should be maintained. Far from a "windfall", there has been the expense of litigation all the way to this Court.

Petitioner speaks of the rule adopted by the Court of Appeals as "punitive in character" (pet., p. 6). We respectfully submit that the rule is no more penal than any other application of the doctrine of constructive trust and that it is sound public policy since it provides a meaningful sanction for the requirements of Sections 47(a) and 61 of the Bankruptcy Act, 11 U.S.C. §§ 75a, 101.

Furthermore, we respectfully submit that petitioner is in no position to complain of being held liable as a constructive trustee. It would have suffered no loss if it had followed normal banking practices. Advised from the face of the check (JA 30) that the funds it received were bankruptcy funds paid pursuant to a specified court order, which order said that the funds were to be held pending

further judicial determinations (JA 36), it carelessly, if not corruptly, issued a certificate of deposit in the individual name of the receiver and two months later transferred, without judicial sanction, the funds to his individual credit in Miami (PA 5a, 24a). Had it refrained from taking these two wholly indefensible steps, the funds would have remained in petitioner's possession available for delivery to Joy's successor as receiver or trustee and the question of its liability for accepting a deposit when not designated would have been totally academic.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Leo H. Hirsch, Jr.
Counsel for Respondent
American Fidelity Fire Insurance Company